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25 November 1985

MEMORANDUM FOR: Karen Ware
 East Europe Division
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 Department of Commerce

FROM

:

Chief, East-West Regional Branch
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 Office of European Analysis

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SUBJECT : Comments on the OECD Report on Eastern Europe's Trade Prospects with the West

1. We agree with the OECD Secretariat's observation that Eastern Europe's improved trade performance in 1984 contributed to a resurgence of Western creditor confidence in the region that allowed increases in lending at rates and terms favorable to Eastern Europe. The Secretariat's paper is correct in pinpointing buoyant Western demand as a major contributor to Eastern Europe's good 1984 performance and rightly notes that the region remains highly dependent on swings in Western economic cycles. The paper correctly concludes that East European trade problems have not been surmounted, as poor East European trade performance for the first half of 1985 aptly demonstrates. (U)

2. But we believe the paper is overly optimistic about the medium-term outlook for East-West trade. The paper sees growing interest by the East European countries in joint ventures with Western partners and the purchase of technology licenses. It fails to mention, however, that Eastern Europe offers few incentives to attract Western business partners and that even the financially sound countries remain reluctant to spend foreign exchange on imports of Western capital goods. Priority uses of foreign exchange remain debt servicing and maintaining hard currency current account surpluses to boost creditworthiness. (U)

3. The paper fails to address other obstacles that are likely to hamper East-West trade. A significant issue is the Soviet Union's stiffening demand for more and better quality goods from its East European partners in exchange for continued deliveries of Soviet oil and raw materials. Recent declines in most of Eastern Europe's trade deficits with the Soviet Union suggest that Moscow is serious about decreasing its subsidization of the East European economies. Meeting these demands could reduce the volume of goods available for export to the West. Other obstacles that may limit Eastern Europe's export potential, and thus East-West trade, include slowing Western economic

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growth, increasing Western protectionism, and intensified competition from the NICs (Newly Industrialized Countries). (U)

Comments on Specific Sections of the Paper

PART I

General Assessment

Para 2: We disagree that "emphasis placed by the East European countries on the key role of intra-CEMA trade" reflects "economic necessity." In our opinion, Soviet pressures and the underlying weaknesses of the East European centrally planned economies are more powerful forces. (U)

Para 3: The improved East European financial climate reflects not only the countries' success in improving their trade position since 1982, but also the lack of better lending opportunities for Western commercial banks elsewhere. (U)

Para 4: Seems overly optimistic about the outlook for East-West trade. We suggest substituting some comments regarding the above-mentioned difficulties Eastern Europe will face in trying to expand exports and trade despite their efforts to attract Western business through cooperation and joint ventures. (This comment also applies to para. 39) (U)

Part I: Intra-CEMA Economic and Trade Relations

Para 12: We believe the statement that the Soviet Union seems ready to abandon fixing the price of oil on the basis of average world prices is incorrect. The CEMA Executive Committee announced in January 1985 no change in the pricing formula for 1986-90. (U)

Para 25: We do not believe that Romania imported 1 million tons of oil from the USSR for hard currency. (U)

Para 26: We believe the method used here to estimate quantity of Soviet oil exports to Eastern Europe is extremely fallible, because:

- special long-term agreements exist whereby countries purchase oil at low prices in exchange for investment in the USSR (e.g., Czechoslovakia's long-term agreement for 5 mmt of oil at low prices).
- Soviet statistics include reexports of middle-Eastern oil, some of which may have gone to the CEMA-6 countries. (U)

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Part II: The East European Countries' Trade PolicyB. Financial Trends

Para 35: While more East European countries have borrowed on Western financial markets in 1985, not all have. Bankers have been relatively eager to lend to the GDR, Hungary, Bulgaria, and Czechoslovakia, but have been reluctant to lend to Romania, and have refused to extend new credits to Poland. (U)

Bulgaria's credits so far this year are large by Sofia's standards and, in our opinion, do indicate a significant departure from the country's normally conservative borrowing policy. (U)

Para 36: While the GDR's new stock of funds would allow it to increase imports of Western goods substantially in the next five-year period, there is no solid evidence that East Berlin intends to do so. (U)

Para 40: We reiterate that not all of the East European countries have successfully borrowed from Western banks. The Western creditors' willingness to lend to Eastern Europe has principally resulted from a lack of comparably attractive investments elsewhere. We stress that it does not represent renewed enthusiasm over Eastern Europe's trade performance. In addition, we believe that if the region's trade balance continues to slide in 1985 as preliminary data indicates, bankers will be less eager to lend to Eastern Europe, particularly at the favorable terms that they have extended so far this year. (U)

It is primarily Hungary's financial market policies which have become more differentiated. (U)

C. Trade Position of the East European Countries in the First Half of 1985

Para 42: East European member countries' statistics for the first half of 1985 expressed in national currencies and then converted to dollars do indeed show a worsening in the countries' hard currency trade performance. (U)

PART IIPoland

The Polish hard currency trade situation continued to deteriorate in the first 10 months of 1985 compared to the same period last year. The surplus was \$861 million--down from \$1.4 billion last year--because exports fell about 2 percent in

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constant prices while imports rose by almost 11 percent. Besides the poor quality of the goods offered abroad, exports to the West did not rise due to the regime's failure to implement a viable pro-export policy. Enterprises still do not find it profitable to export, but prefer to sell on the domestic market. (U)

Para 49: Coal exports to the West decreased about 17 percent in the first six months of 1985 compared to the same period last year, causing a \$100 million loss in potential hard currency earnings. Polish coal prices in early 1985 on the world market were roughly unchanged from last year. Although the average price per ton of Polish coal remained lower than world prices, the price for Polish coal rose about \$1 to \$2 per ton in the second half of this year. (U)

Coal output should be measured in million tons rather than million dollar tons. (U)

Para 50: The terms "export to" or "import from" "outside the region" are unclear. Does this mean total hard currency trade? (U)

Para 52: Poland does not plan to invest in those projects which could lead to large increases in exports. Instead, many outdated projects first started in the 1970s are slated to be completed in the next five years. Warsaw has not fulfilled its plan to direct a third of total investments to the food industry and the agricultural sector. Implementing such a program eventually could lead to a decrease in those type of imports and even an increase in exports. (U)

Romania

Para 53: We believe the sentence "Romania's closer ties with the CEMA countries and the Soviet Union in particular have much to do with its growing energy problem" could be re-worded. Romania wants to develop closer ties with the Soviet Union, in part, to receive more Soviet oil and gas. Starting next year, Romania will reportedly receive crude oil from the USSR on the same clearing account basis as the other East European countries. Romania also is participating, like other East European countries, in joint investment projects such as the Progress gas pipeline in exchange for additional gas deliveries. (U)

We believe the figures of 1.8 million and 1.0 million tons of Soviet oil are inaccurate. (U)

Hungary

Para 55: In regard to attaining this year's trade surplus of \$700 million, Budapest revised forecasts to \$300-350 million

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earlier this year. It is forecasting that the current account might be in balance this year, but recent data indicate that the current account may slip into deficit. We stress, however, that Hungarian trade is highly seasonal and that it always does better in the second half of the year. (U)

The decline of exports of agricultural goods and traditional manufactures can be attributed not only to negative price trends, but also to stronger foreign competition. Another important factor accounting for poor trade results with nonsocialist countries is the marked reduction of re-exported Middle Eastern oil. (U)

The paper should mention that the nonconvertible currency trade balance developed much as planned. Ruble denominated trade is in surplus for the first time in more than a decade. (U)

Para 56: The new five-year plan will retard growth in consumption and investment until 1988 because Hungary must initially focus on restoring external equilibrium. During the plan Hungary is expected to emphasize the technological upgrading of its industry. Areas singled out for investment priority include electronics, robotics, and biotechnology in addition to those mentioned in the OECD draft. (U)

Bulgaria

The section on Bulgarian economic performance (paragraphs 57-59) should open with a clearer statement of Bulgaria's current economic problems. For example: After relatively good economic performance in 1980-84, figures for the first half of 1985 suggest that Bulgaria will fall short of planned targets this year. Shortfalls in agriculture and in key industrial sectors--especially energy--have hurt overall economic performance. (U)

The report should clarify that the statistics on industrial output, chemical output, and electric power production are official Bulgarian statistics. These statistics are upward biased as is discussed below in the comments on the East German section. Moreover, the Bulgarians have not yet reported official grain harvest results. The statement that the harvest is down 30 percent on 1984 results is an estimate. (U)

Bulgaria's industrial and agricultural performance is not the only problem affecting its trade balance. Pressure from Moscow to balance trade and divert top quality industrial and consumer goods from trade with the West to trade with the USSR, and declining trade surpluses with important LDC partners also have hurt Bulgaria's hard currency trade balance. (U)

It is currently unclear how Bulgaria intends to spend the \$450 million that it has borrowed this year. A part may go to

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restructure Bulgaria's modest debt and increase imports of grain and coal to rebuild stocks. In addition to financing expanded investment in energy development and agro-industry, Sofia also is likely to increase imports of Western capital equipment to modernize its high-priority machine-building and electronics industries. (U)

East Germany

Para 60: The highly favorable picture of East Germany's GNP growth illustrates what we consider one of the sources of excessive optimism about these economies. Such statistics for most of the CEMA countries are seriously flawed in a way that generally overstate rates of growth. The main causes for these distortions relate to the well-known problems of disguised inflation and changes in double counting.

(U)

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Czechoslovakia

We agree with the conclusions on Czechoslovak foreign trade, trade policy, and investment priorities on the eve of the next five-year plan. The following comments offer different emphasis, give additional background on developments not covered in the paper, and note some statistical discrepancies between data in the TC/WP's paper and other sources. (U)

Para 65: The third sentence beginning with "In the first six months of 1985..." notes that "trade with non-socialist countries fell in absolute terms for both exports and imports (down by 7.2 percent and 5.9 percent respectively)." According to the PlanEcon Report for Czechoslovak Half-Year Performance (Vol., No. 3, p.9), official trade statistics indicate that export quantities for the first half of 1985 fell by 9.0 percent, and import quantities fell by 7.8 percent for the period. According to PlanEcon estimates of trade values (i.e., incorporating price changes), exports (fob) to non-socialist countries during the first half of 1985 dropped by 14.5 percent, and imports (cif) by 13.3 percent. We believe therefore that the TC/WP's trade figures may understate the retrenchment of Czechoslovak foreign trade with non-socialist countries for the first half of 1985. (U)

The paper correctly notes the striking decline in Czechoslovak trade with the LDCs; according to the PlanEcon estimates cited above, the value of export to LDCs fell 19.7 percent in the first half of 1985 and imports fell by 17.7. This decline is due to financial austerity in the Third World, particularly in some Arab countries which had been large buyers of Czechoslovak arms. (U)

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Para 66: The second sentence beginning "In particular..." notes Prague's recent indication that it would consider joint ventures "...apparently raises no problems of principle from a legal standpoint..." The meaning of this sentence is obscure: if it means no problems from the standpoint of Czechoslovak legal principle, then we disagree with the assertion because Prague has established fairly strict conditions for joint ventures:

- foreign ownership is limited to a 49 percent maximum share
- all joint ventures must be managed by Czechoslovak citizens; foreigners are only allowed to serve as executive deputies
- remuneration and remittance of salaries abroad will be subject to some limited
- the approved "set of principles" for joint ventures includes an explicit statement that "the joint venture is not supposed to be an inherent part of the Czechoslovak economic and planning system."

These regulations suggest that the regime's new tolerance for joint ventures remains a controversial measure taken only out of necessity, and still poses considerable legal, political, and ideological problems for Prague. (U)

Para 68: A sentence should be devoted to Czechoslovakia's heavy commitment to increasingly costly joint investments in Soviet energy and raw materials extraction projects. Coming when the domestic Czechoslovak economy itself requires modernization of its own obsolescent capital stock, such ventures tie up scarce investment resources in projects with a dubious economic rationale. (U)

Para 68: We question the statement in the fourth sentence beginning "These new responsibilities..." that investments in new chemical and light industries "could have a beneficial impact on the whole Czechoslovak economy..." In our view, the Czechoslovaks primarily are responding to Soviet demands for more and better goods, particularly in the light industries; and the domestic economy may not gain all that much from the new investments. (U)

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